In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-1039

JOSEPH B. ZYCHINSKI AND MARIE H. ZYCHINSKI, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A, A-1 to A-13) are reported at 60 T.C. 950. The opinion of the court of appeals (Pet. App. B, A-14 to A-18) is reported at 506 F.2d 637.

JURISDICTION

The judgment of the court of appeals was entered on November 25, 1974, and its order denying rehearing was entered on December 17, 1974 (Pet. App. C, A-19). The petition for a writ of certiorari was filed on February 20, 1975. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Sections 1371-1379 (Subchapter S) of the Internal Revenue Code of 1954 generally permits the shareholders of certain qualifying small business corporations to elect to be taxed as if they were members of a partnership. Section 1372(e)(5) provides that the election shall terminate for any taxable year in which more than 20 percent of the corporation's gross receipts constitute "passive investment income," which is defined to include "gross receipts derived from * * * sales or exchanges of stock or securities* * * ."

The question presented is whether a corporate securities dealer's gains from the sale of securities constitute "passive investment income" within the meaning of Section 1372(e)(5) so as to terminate its Subchapter S election.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 1372 of the Internal Revenue Code of 1954 and of Section 1.1372-4 of the Treasury Regulations are set forth in the Appendix, *infra*.

STATEMENT

Petitioners owned all but 101 of the 4,000 shares of Henry J. Richter & Company. Petitioner Joseph B. Zychinski owned 100 shares of stock of the corporation and was its treasurer.[1] Prior to the commencement of its taxable year ended October 31, 1966, the corporation filed an election to be taxed as a small business (Subchapter S) corporation, and for its taxable years ended October 31, 1966 and 1967, filed its federal income tax reports on that basis (Pet. App. A, A-3).

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[1]Marie H. Zychinski is a party solely because she filed joint income tax returns with her husband for the years at issue.

During those years, the corporation was in the securities business. The greater part of its activities was the purchase and sale of securities for its own account, for and from the inventory which it maintained for that purpose. The majority of those sales were "wholesale" sales to broker-dealers.

In accordance with the practices of the securities industry, the corporation "made a market" in over-the-counter securities by publishing and advertising in trade circles that it would buy or sell such securities from or to other securities dealers; as a qualified securities dealer, it was required to make purchases and sales in accordance with those offers. As a result, the corporation purchased, sold and maintained an inventory of 50 to 100 different securities traded in the over-the-counter market, maintained offers to purchase and sell listings in the listings service (the "pink sheets"), and advertised in trade journals and newspapers. It also made some "retail" sales to buyers who were not broker-dealers. The corporation was registered with the Securities and Exchange Commission as a broker-dealer, was a member of the Midwest Stock Exchange and the National Association of Securities Dealers (Pet. App. A, A-4, A-6).

During the taxable years in issue, the corporation's principal income was approximately $231,000 in net gains from trading in securities for its own account, which far exceeded 20 percent of the Company's gross receipts. However, it did not purchase any securities for "investment" during those years and it reported no sales of securities as capital transactions (Pet. App. A, A-5).[2]

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[2]Section 1236 of the Code allows a dealer in securities to segregate those securities held for investment and not held primarily for sale to customers in the ordinary course of his trade or business, provided the dealer identifies them as held for investment and maintains adequate accounting records. The effect of Section 1236 is to allow a dealer in securities to report transactions in investment securities as capital transactions.

On audit, the Commissioner of Internal Revenue determined that the Subchapter S election of the corporation had terminated, because more than 20 percent of its gross receipts were from "passive investment income," which Section 1372(e)(5)(C) of the 1954 Code defines to include gains "derived from sales or exchanges of stock or securities * * *." As a result, he disallowed petitioners' claimed deductions of their pro rata shares of the corporation's losses. The Tax Court upheld the Commissioner's determination (Pet. App. A, A-7 to A-13) and the court of appeals affirmed (Pet. App. B, A-14 to A-18).

ARGUMENT

1. Section 1372(a) of the Code provides that "any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter." Generally, the effect of such a "Subchapter S" election[3] is that the corporation is not subject to the income tax but that its net income or operating loss is reportable pro rata by its shareholders as if they were members of a partnership (Sections 1373(a), 1374(a)). Section 1372(e)(5), however, provides that a corporation's Subchapter S election shall terminate if, after its first two years of engaging in a trade or business, its "passive investment income" exceeds 20 percent of its gross receipts. Section 1372(e)(5)(C) defines "passive investment income" as "gross receipts derived from * * * sales or exchanges of stock or securities" to the extent of the gains therefrom. Treasury Regulations, Section 1.1372-4(b)(5)(x), Appendix, *infra*, p. 12, makes the "passive investment income" limitation explicitly applicable to securities dealers, by providing that —

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[3]Sections 1371-1379 comprise Subchapter S of Chapter 1 of Subtitle A of the Code, and are commonly referred to as "Subchapter S."

> Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities.

Here, it is undisputed that the corporation's gains from sales and exchanges of stock or securities exceeded 20 percent of its gross receipts. Thus, under the Code and Regulations, the court of appeals correctly concluded that the corporation's gross receipts from such sales were "passive investment income" under Section 1372(e)(5)(C) so that its Subchapter S election terminated. In providing that gains from the sale of securities by securities dealers are included in the statutory term "sale or exchange of stocks and securities," the Regulation is "prima facie proper, comporting * * * with the ordinary understanding" of the statutory term. *Bingler* v. *Johnson*, 394 U.S. 741, 751. See also *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501. Since the statute was reenacted in 1966, Congress is deemed to have approved the Regulation. See, *e.g.*, *United States* v. *Correll*, 389 U.S. 299, 305-306; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Fribourg Nav. Co.* v. *Commissioner*, 383 U.S. 272, 283.

Petitioners argue (Pet. 6) that the general term "passive investment income" in Section 1372(e)(5) was not meant to cover gains from the sale of securities by a corporation actively engaged in dealing in securities. Nothing in the statute or its legislative history supports that conclusion. The term "passive investment income" cannot be interpreted in a vacuum, as petitioners would do, and given a colloquial meaning that would exclude income from "active" business from the 20 percent rule. See *Western Union* v. *Lenroot*, 323 U.S. 490, 502; *Fox* v. *Standard Oil Co.*, 294

U.S. 87, 95-96.[4] To the contrary, "passive investment income" is a technical term defined with precision in Section 1372(e)(5)(C) to include various items, including "gross receipts derived from * * * sales or exchanges of stock or securities * * * ."

2. The courts have generally held that the specific types of income set forth in Section 1372(e)(5)(C) are subject to the 20 percent rule, without regard to the degree of passiveness of the corporate business operations. Thus, for example, the Ninth Circuit has held, in conformity with the decision below, that the gross receipts of a corporate securities dealer from gains from the sale of securities cannot exceed 20 percent of its total gross receipts without termination of its Subchapter S election. *Buhler Mortgage Co.* v. *Commissioner*, 443 F.2d 1362, affirming *per curiam*, 51 T.C. 971. To the same effect are *Marshall* v. *Commissioner*, 510 F.2d 259 (C.A. 10), and *Doehring* v. *Commissioner*, 33 T.C.M. 1035, decided September 10, 1974, appeal pending, C.A. 8, No. 75-1148, both of which held that interest income of a small loan company was subject to the 20 percent maximum limitation of Section 1372(e)(5)(C).[5]

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[4]There is no basis to petitioners' further argument (Pet. 11-12) that the active-passive test is embodied in another Regulation (Section 1.1372-4(b)(5)(vi)) under Section 1372(e). That Regulation deals with the entirely different problem of what portion of a payment is for rent—*i.e.*, "Consideration paid for use or occupation of property" (Black's Law Dictionary (Rev. 4th ed.), p. 1461)—and what portion is for services. The Regulation excepts payments from the statutory term "rent" if they are in exchange for "significant" services, although the courts have held that this exception is to be narrowly interpreted (*City Markets, Inc.* v. *Commissioner*, 433 F.2d 1240 (C.A. 6); *Bramlette Building Corp.* v. *Commissioner*, 424 F.2d 751 (C.A. 5)). Here, however, no comparable allocation problem exists since all of the receipts were within the statutory term "gross receipts derived from * * * sales or exchanges of stock or securities."

[5]The same rationale has been employed by the Second Circuit in interpreting Section 23(g)(4) of the 1939 Code, which limited loss deductions on stock to corporations whose income was derived "from sources other than * * * interest * * * or gains from sales or exchanges of stock or securities." 26 U.S.C. (1952 ed.) 23 (g)(4). The court held that this limitation applied to banks, regardless of the fact that the bank in question was an "operating" company. *Commissioner* v. *Adam, Meldrum & Anderson Co.*, 215 F.2d 163, certiorari denied, 348 U.S. 913.

Petitioners contend (Pet. 6) that the decision below conflicts with *House* v. *Commissioner*, 453 F.2d 982 (C.A. 5). There, the court held that the pre-1966 version of Section 1372(e)(5) did not affect gross receipts from interest received by a corporation in the small loan business. In the court's view, the 20 percent rule did not apply to such a corporation because the then-existing descriptive title of the statute was "Personal Holding Company Income" and the taxpayer came within a specific exception to the definition of "personal holding company" for a corporation engaged in "the active and regular conduct of a lending or finance business." See Section 542(c)(6) of the Code.

There is no conflict of decisions warranting review by this Court. Unlike *House*, this case involves the post-1966 version of Section 1372(e)(5), in which the descriptive title was changed to "Passive Investment Income." Although the committee reports indicate that this change of terminology in the title was not intended to alter the meaning of the statute (see S. Rep. No. 1007, 89th Cong., 2d Sess. 20 (1966)),[6] the fact that the Fifth Circuit in *House* relied upon the now-eliminated descriptive title "Personal Holding Company Income" effectively distinguishes that case. Here, in contrast to *House*, there is no comparable specific exception in the personal holding company provisions applicable to petitioners for income received by securities dealers from gains from the sale or exchange of stock or securities.[7] Thus, even assuming *arguendo* that the

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[6]Indeed, Section 7806(b) of the Code explicitly provides that such descriptive matter in the statutory titles is not to be given any legal effect.

[7]Prior to 1964, Section 543(a)(2) had defined "personal holding company income" to include gains from sales or exchanges of stock or securities "[e]xcept in the case of regular dealers in securities * * *." 26 U.S.C. (1958 ed.) 543(a)(2). However, that substantive provision was eliminated by Section 225(d) of the Revenue Act of 1964, Pub.L. 88-272, 78 Stat. 81.

personal holding company provisions continue to offer a relevant guide to the construction of the post-1966 version of Section 1372(e)(5), the rationale of *House*, which heavily relied upon the specific exception in the personal holding company provisions, would not apply to this case,[8] where the corporation was not a personal holding company simply because it had no "personal holding company income". See Section 543(a) of the Code. In sum, while the Fifth Circuit may continue to follow *House* with respect to finance companies,[9] it has not yet extended the rationale of that case to exempt any corporation that is not a personal holding company from the 20 percent rule of Section 1372 (e)(5).[10]

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[8]The Fifth Circuit in *House* also relied upon the district court's decision in *Valley Loan Association* v. *United States*, 258 F. Supp. 673 (D. Colo.), which the Tenth Circuit disapproved and effectively overruled in *Marshall* v. *Commissioner*, *supra*.

[9]The Fifth Circuit will shortly have an opportunity to reconsider its holding in *House* in the context of a pre-1966 case. See *Puckett* v. *Commissioner*, 33 T.C.M. 1038, decided September 10, 1974, appeal pending, C.A.5, No. 75-1913, where the Tax Court upheld the taxpayer's position. While the Tax Court reached a contrary result in *Doehring* v. *Commissioner*, *supra*, 33 T.C.M. 1035, decided September 10, 1974, appeal pending, C.A. 8, No. 75-1148, the divergency of results is a consequence of that court's application of its *Golsen* rule (*Golsen* v. *Commissioner*, 54 T.C. 742, 757, affirmed, 445 F.2d 985 (C.A. 10), certiorari denied, 404 U.S. 940), pursuant to which it decides cases in conformity with the law of the applicable circuit to which an appeal might be taken. Since the Fifth Circuit has already ruled on the issue in *House*, the Tax Court held for the taxpayer in *Puckett*. However, because the Eighth Circuit has not ruled on a pre-1966 case involving a finance company, the Tax Court in *Doehring* felt free to apply the rule of its own prior decisions in favor of the Commissioner. Contrary to petitioner's argument (Pet. 12), this divergence of results by the Tax Court is not a conflict of decisions warranting review by this Court.

[10]We are advised by the Internal Revenue Service that the issue does not presently have any significant administrative importance. Apart from the *Puckett* and *Doehring* cases, there are no other cases pending in the courts presenting this issue. There are a total of six cases pending administratively, in which the total amount of taxes at stake is approximately $380,000.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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MAY 1975.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 1372 [as added by Sec. 64(a), Technical Amendments Act of 1958, Pub.L. 85-866, 72 Stat. 1650]. ELECTION BY SMALL BUSINESS CORPORATION.

* * * * *

(e) *Termination.*—

* * * * *

(5) [as amended by Sec. 3(a), Act of April 14, 1966, Pub.L. 89-389, 80 Stat. 114] *Passive investment income.*—

(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

(ii) the amount of passive investment income for such taxable year is less than $3,000.

(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

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Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ *1.1372-4 Termination of election.*

(b) Methods of termination— * * *

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(5) *Passive investment income*— * * *

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(vi) *Rents.* The term "rents" as used in section 1372 (e)(5) means amounts received for the use of, or right to use, property (whether real or personal) of the corporation. The term "rents" does not include payments for the use or occupancy of rooms or other space where significant services are also rendered to the occupant, such as for the use or occupancy of rooms or other quarters in hotels, boarding houses, or apartment houses furnishing hotel services, or in tourist homes, motor courts, or motels. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only. The supplying of maid service, for example, constitutes such services; whereas the furnishing of heat and light, the

cleaning of public entrances, exits, stairways and lobbies, the collection of trash, etc. are not considered as services rendered to the occupant. Payments for the use or occupancy of entire private residences or living quarters in duplex or multiple housing units, of offices in an office building, etc., are generally "rents" under section 1372(e)(5). Payments for the parking of automobiles ordinarily do not constitute rents. Payments for the warehousing of goods or for the use of personal property do not constitute rents if significant services are rendered in connection with such payments.

(x) *Gross receipts from the sale of stock or securities.* For purposes of section 1372(e)(5), gross receipts from the sales or exchanges of stock or securities are taken into account only to the extent of gains therefrom. Thus, the gross receipts from the sale of a particular share of stock will be the excess of the amount realized over the adjusted basis of such share. If the adjusted basis should equal or exceed the amount realized on the sale or exchange of a certain share of stock, bond, etc., there would be no gross receipts resulting from the sale of such security. Losses on sales or exchanges of stock or securities do not offset gains on the sales or exchanges of other stock or securities for purposes of computing gross receipts from such sales or exchanges. Gross receipts from the sale or exchange of stocks and securities include gains received from such sales or exchanges by a corporation even though such corporation is a regular dealer in stocks and securities. For the meaning of the term "stock or securities", see paragraph (b)(b)(i) of § 1.543-1.